Supreme Court, U.S.
FILED
JUL 17 1996
CLERK

No. 95-1855

In the Supreme Court of the United States

OCTOBER TERM, 1995

GERALD G. BARTON AND WILLIAM W. VAUGHAN, III,
PETITIONERS

v.

LANDMARK LAND COMPANY OF CAROLINA,
INCORPORATED

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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16 pp

QUESTION PRESENTED

Whether the court of appeals correctly held that petitioners, former officers and directors of a failed savings and loan and its subsidiaries, were not entitled to indemnification from the subsidiaries for their costs in defending themselves against Office of Thrift Supervision civil penalty proceedings arising out of alleged wrongdoing by petitioners in their management of the failed institution.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-33) is reported at 76 F.3d 553. The orders of the district court (Pet. App. 34-39, 40-52, 201-211, 213-214) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on February 15, 1996. The court of appeals denied a petition for rehearing on April 2, 1996 (Pet. App. 56-199), and denied a motion for reconsideration of that petition on April 15, 1996. Pet. App. 53-55. The petition for a writ of certiorari was filed on May 15, 1996.

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Gerald G. Barton and William W. Vaughan, III (petitioners) were directors of first and second tier subsidiaries (Debtors) of Oak Tree Savings Bank, S.S.B. (Bank), which was wholly owned by Landmark Land Company, Inc. (Landmark). In addition, Barton was chairman of the board of directors and chief executive officer of Landmark and the Bank, and Vaughan was a director and officer of the Bank. Pet. App. 6-7.

1. In June, 1990, the Office of Thrift Supervision (OTS) determined that the Bank was undercapitalized and had demonstrated a pattern of consistent losses.[1] On January 15, 1991, petitioners, as directors of the Bank, signed a Consent Agreement with the OTS, indicating that the Bank was near failure and an OTS takeover was imminent. In the Consent Agreement, petitioners agreed that the Bank's subsidiaries (the Debtors) would not enter into any material transactions without prior approval from OTS. Pet. App. 8. Nonetheless, on October 11, 1991, without securing OTS approval, the Debtors filed for bankruptcy in the United States District Court for the District of South Carolina. Pet. App. 6.

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[1] The OTS was created in 1989 in response to the crisis in the savings and loan industry, which occurred as the result of the failure of a number of undercapitalized savings and loan institutions. In order to prevent a similar crisis in the future, Congress endowed the OTS with the regulatory authority to ensure that savings and loan institutions remained adequately capitalized. Pet. App. 24.

Anticipating that the OTS would act quickly to take control of the Bank, the Debtors obtained a temporary restraining order and then a preliminary injunction from the bankruptcy court, preventing the Bank from exercising its shareholder rights to remove and replace the management of the Debtors. Pet. App. 8, 10. On October 13, 1991, the OTS took control of the Bank and appointed the Resolution Trust Corporation (RTC) to act as the Bank's receiver. Pet. App. 8. The RTC was not able to exercise its statutory right and duty to take control of the Debtors until the court of appeals lifted the injunction against the Bank on August 18, 1992. See *In re Landmark Land Co. of Oklahoma, Inc.*, 973 F.2d 283 (4th Cir. 1992).

2. In the meantime, in response to the bankruptcy filings, the OTS filed civil administrative charges against petitioners. The charges alleged that petitioners knew that filing for bankruptcy on behalf of the Debtors would impair the Bank's ability to collect on its lines of credit to the Debtors, and thus that petitioners breached their fiduciary duties as directors of the Bank. The OTS also charged petitioners with violating the terms of the Consent Agreement, alleging that the bankruptcy filings constituted material transactions made by the Bank's subsidiaries without OTS approval. As a result of these violations, the OTS assessed a civil penalty of $1 million against petitioners. Pet. App. 9.

3. During the eleven-month period in which the bankruptcy court injunction remained in effect and the Debtors' original boards of directors remained in control, petitioners arranged for the Debtors to pay for the fees and costs of their defense against the OTS charges. On March 26, 1992, the Debtors filed a

reimbursement motion requesting permission to use corporate funds to indemnify petitioners and others. Pet. App. 11. The district court held a hearing on the reimbursement motion on June 3, 1992, and still had the motion under advisement when the injunction was lifted and the RTC gained control of the Debtors. On September 12, 1992, after the injunction was lifted, the RTC replaced the Debtors' boards of directors. On November 5, 1992, the RTC moved to withdraw the reimbursement motion. However, the district court refused to permit the withdrawal because it had already heard argument and taken the motion under advisement. Pet. App. 12-13.

On May 27, 1994, the district court granted the reimbursement motion, finding "that the evidence demonstrates that the officers and directors of the Debtor companies sought the protection of the bankruptcy court in good faith." Pet. App. 51. Subsequently, on October 5, 1994, the court clarified its earlier order, holding that petitioners should be indemnified "if and when [they] prove by a preponderance of the evidence that they have incurred reasonable expenses in defending themselves for actions taken in good faith with the reasonable belief that such actions were not opposed to the best interests of the Debtor companies." Pet. App. 210.

4. The court of appeals reversed the district court's reimbursement order. Pet. App. 33. Applying the applicable state corporate codes, the court of appeals noted that a corporation must indemnify its agents for costs incurred while *successfully* defending themselves in a legal proceeding arising out of their service to the corporation. Where, as here, the agents have not (at least yet) completely vindicated themselves, the corporation may nonetheless choose to

indemnify them, but only if the agents "could have acted in good faith and in the best interests of the corporation [even] if the charges against [them] turn out to be true." Pet. App. 21. Thus, when "the agent's alleged misconduct, if true, demonstrates that the agent acted in bad faith, the * * * court should deny permissive indemnification" and should grant indemnification only if the agent subsequently succeeds on the merits, thus proving that the allegations of bad faith were false. Pet. App. 21-22.

Applying this standard to the instant case, the court of appeals noted that the district court did not articulate "how the [petitioners] could have acted in good faith if the OTS charges filed against them were true." Pet. App. 22-23. In fact, "[i]f the OTS charges are accurate, [petitioners'] action to place the Debtors in bankruptcy was a deliberate attempt to prevent the OTS from exercising control over the Bank's assets, thus hindering the OTS's ability to deal effectively with a failing savings and loan." Pet. App. 25. According to the OTS charges, petitioners "used the bankruptcy code to stymie the OTS, even though their action breached the Consent Agreement with the OTS and violated their fiduciary duties to the Bank." *Ibid.* The court therefore concluded that, if the OTS charges are true, petitioners did not act in good faith. Such a "blatant attempt to circumvent the OTS's regulatory authority" cannot constitute good faith conduct, even if it was in the best interest of the corporation. Pet. App. 25-26. The court of appeals denied preliminary permissive indemnification, noting that if the OTS fails to prove the charges against petitioners in the administrative proceeding, petitioners will be entitled to mandatory indemnification at that time. Pet. App. 17, 21 n.8.

ARGUMENT

The decision of the court of appeals does not conflict with any decision of this Court or any other federal or state appellate court. Moreover, the decision below was based entirely on the application of state law, and thus presents no issue of national importance. Finally, the court of appeals' analysis was correct on the merits, and will not have any impact on the operation of the bankruptcy system.

1. a. The basic legal issue posed by the decision below is whether, under the law of the Debtors' respective States of incorporation, petitioners were entitled to indemnification during their defense against the OTS charges. No other federal or state appellate court has decided whether a deliberate attempt to frustrate the regulatory authority of a federal agency can constitute "good faith" conduct within the meaning of state indemnification statutes, nor has any other federal court of appeals decided whether actions that are wrongful, but still in the best interest of the corporation, can constitute "good faith" conduct under those statutes. One state court has faced the latter issue, and the decision of the court below is in accord with that state decision. See *Plate* v. *Sun-Diamond Growers of California*, 275 Cal. Rptr. 667, 673 (Ct. App. 1990) (wrongful conduct against a third party precludes a finding of good faith, even if the conduct was in the best interest of the corporation). Thus, the decision below creates no conflict of authority requiring this Court's resolution.

b. Petitioners claim that the court of appeals held that the bankruptcy filings constituted a violation of the Consent Agreement. Pet. 8-9. Petitioners cite a

number of cases for the proposition that the right to file in bankruptcy court cannot be contracted away.[2] Petitioners then argue that the court of appeals' conclusion that the Consent Agreement contractually precluded the Debtors from filing for bankruptcy conflicts with those decisions. Pet. 9-10. The court of appeals, however, did not purport to resolve the issue of whether or not the bankruptcy filings were in breach of the Consent Agreement. The court took that allegation as true solely for the purpose of determining whether permissive indemnification, *i.e.*, reimbursement of corporate agents for their expenses in connection with a legal proceeding that is still pending, was properly granted. Pet. App. 21. The question whether the bankruptcy filings violated the Consent Agreement remains open. If petitioners establish in the civil administrative proceeding brought by the OTS that the filings did not or legally could not violate the Consent Agreement (and they also prevail on the merits with respect to the other

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[2] The cases petitioners cite establish the "well settled principle that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy." *In re Tru Block Concrete Products, Inc.*, 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983). A consent agreement that precludes a bank that anticipates an OTS takeover from causing its debtor-subsidiaries to file for bankruptcy for the sole purpose of preventing the OTS-controlled bank from collecting on its lines of credit to the subsidiaries can, however, hardly be considered contrary to public policy. Such an agreement *furthers* the public policy behind the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C.) which created the OTS in order to ensure that savings and loan institutions remain adequately capitalized. Pet. App. 24.

charges against them), they will be entitled to mandatory indemnification. See Cal. Corp. Code § 317(d) (West Supp. 1996).

2. a. The decision below rested solely on an interpretation of state statutory law. Petitioners sought reimbursement under California's permissive indemnification statute, which provides that

> [a] corporation shall have the power to indemnify any person who was or is a party or is threatened to be made a party to any proceeding * * * if that person acted in good faith and in a manner the person reasonably believed to be in the best interests of the corporation.

Cal. Corp. Code § 317(b) (West Supp. 1996).[3] Relying on a California case interpreting this statute, *Plate* v. *Sun-Diamond Growers of California*, 275 Cal. Rptr. 667 (Ct. App. 1990), the court concluded that permissive indemnification will not be permitted when an officer is accused of engaging in wrongful conduct against a third party, even if that conduct benefitted the corporation. Pet. App. 25-26. The OTS allegations, if true, indicate that petitioners' purpose in filing for bankruptcy was to frustrate the ability of the OTS to carry out its regulatory authority, and that the bankruptcy filings violated the Consent

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[3] Other officers and employees of the Debtors sought reimbursement from Debtor corporations that were incorporated in Oklahoma and Louisiana. Since the indemnification statutes of all of these States are nearly identical, the court of appeals focused its discussion only on the California statute. Pet. App. 17 n.5 (citing Cal. Corp. Code § 317 (West Supp. 1996); Okla. Stat. Ann. tit. 18, § 1031 (West Supp. 1996); La. Rev. Stat. Ann. § 12:83) (West 1994)). Only the officers to whom California law applies have sought review in this Court.

Agreement with the OTS and petitioners' fiduciary duties to the Bank. The court found that petitioners would not be entitled to indemnification for this conduct under California law. Pet. App. 26. This decision presents no issue calling for this Court's resolution.

b. Petitioners claim that the court of appeals' interpretation of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C.) is "extreme" (Pet. 6) and hampers the effectiveness of the Bankruptcy Code. Pet. 10-11. This contention is without merit. As explained above, the decision below was based entirely on an interpretation of California law. The court held that, under the "good faith" provision of the California indemnification statute, petitioners' deliberate attempt to frustrate the success of an impending OTS takeover, in violation of their Consent Agreement with the OTS and in breach of their fiduciary duties to the Bank, did not constitute good faith conduct so as to allow for permissive indemnification under that State's law.

3. a. The court of appeals' decision was correct as a matter of California law, and will not have a significant adverse effect on the bankruptcy system. The California indemnification statute states that a corporation may indemnify a person for his or her defense expenses if the person "acted in good faith *and* in a manner the person reasonably believed to be in the best interests of the corporation." Cal. Corp. Code § 317(b) (West Supp. 1996) (emphasis added). Thus, it is clear that the requirement of good faith is independent of, and in addition to, the requirement that the actions be in the best interest of the

corporation. In reaching this conclusion, the court of appeals followed the decision of the California Court of Appeal in *Plate* v. *Sun-Diamond Growers of California*, 275 Cal. Rptr. 667 (1990) ("That such wrongdoing did not harm or was not against the best interests of the corporation does not establish that the defendants acted in good faith in participating in the wrongful conduct."). In deciding that the requirement of good faith cannot be met when the officer acted wrongfully toward a third party, the court of appeals was also following a rule established in *Plate*. See *ibid.* (the fact "that the conduct giving rise to the action consisted of intentional wrongdoing committed against a third party precludes a finding that [the officers] acted in good faith").[4]

If the OTS charges are true, petitioners clearly did not meet this standard of conduct. The OTS charges allege that the bankruptcy filings not only violated the terms of the Consent Agreement, but were also "a deliberate attempt to prevent the OTS from exercising control over the Bank's assets, thus hindering the OTS's ability to deal effectively with a failing savings and loan" (Pet. App. 25).[5] The OTS charges also al-

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[4] Petitioners are mistaken in contending that the court of appeals wrongly construed the good faith requirement as "good faith vis-a-vis the OTS," instead of "good faith vis-a-vis the corporation." Pet. 10. Under California law, petitioners were required to act in good faith not only vis-a-vis the Debtors, but also vis-a-vis third parties.

[5] When an OTS investigation determined that the Bank had insufficient capital to meet the new FIRREA guidelines, the OTS directed the Bank to infuse sufficient capital in order to meet the minimum capital requirement. When the Bank was unable to submit an adequate plan for overcoming deficiencies, the OTS prepared to exercise its statutory right and duty

lege that the bankruptcy filings constituted a breach of petitioners' fiduciary duties to the Bank, because petitioners "knew that the bankruptcy filings would have a substantially adverse effect on the Bank's ability to collect on the secured and unsecured lines of credit to the Debtors." Pet. App. 9. As directors of the Bank, petitioners were under a fiduciary duty not to cause the Debtors to file for bankruptcy, thereby significantly impairing the Bank's financial health. In breaching that duty, petitioners may well have been acting in the best interest of the Debtors, but they were clearly not acting in good faith toward the Bank.

Petitioners argue that California law holds only that criminal acts against third parties will preclude a finding of good faith, and that the court of appeals was mistaken in equating their conduct with criminal activity. Pet. 10. This contention is incorrect. The California Court of Appeal has held that

> [t]he policy considerations behind th[is] statute[] are that persons who serve the corporation in good faith should, in the absence of certain conduct (fraud, *breach of fiduciary duties, etc.*) be free from liability for corporate acts; indemnification encourages capable persons to perform their duties, secure in the knowledge that expenses incurred by them despite their *honesty and integrity* will be borne by the corporation.

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to enforce the minimum capitalization requirement by taking control of the Bank. According to the OTS charges, petitioners' sole reason for placing the Debtors in bankruptcy was to undermine the ability of the OTS to carry out this statutory duty. Pet. App. 24-25.

Plate, 275 Cal. Rptr. at 671 (emphasis added). Controlling California law thus clearly contemplates that the wrongful conduct against third parties need not be criminal.

b. Petitioners claim that, under the decision of the court of appeals, it is "bad faith *per se* for a corporation to seek the protection of the bankruptcy courts merely because doing so frustrates the regulatory authority of a government agency." Pet. 11. This contention is without merit. The court of appeals held only that it is bad faith for a corporation to seek the protection of the bankruptcy courts *for the express purpose* of frustrating the regulatory authority of a government agency, especially when doing so would breach a fiduciary duty and violate a signed consent agreement with agency. Despite petitioners' fears, the decision below does not "divest the bankruptcy courts of jurisdiction to adjudicate matters merely because they fall within the reach of government regulators." Pet. 10.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1996